

The Matching of Expenditures with Income

Unless all of a corporation's taxable income is either apportionable by, or allocable to, the taxing state, an issue arises regarding the treatment of deductions. A corporation must determine which of its expenditures are properly matched with the production of its apportionable income and thus deductible in calculating apportionable taxable income, and which are properly matched with the production of its allocable income and thus deductible in calculating its allocable taxable income.

(Of course, if an expenditure is incurred in generating income that a state does not tax, no deduction should be allowed at all. This principle is embodied in both state and federal law.)

Similar issues arise if a corporation is carrying on more than one unitary business. In that case, it becomes necessary to match an expenditure with the income of the appropriate unitary business.

Developing a detailed set of guidelines for dealing with this issue is outside the scope of our project. But a flagging of the issue seems appropriate. Besides looking to the rules that the various states have developed, the states might want to examine the federal rules. The Internal Revenue Code must distinguish between expenditures that generate U.S. source gross income and those that generate foreign source gross income. A foreign corporation is taxable only on its U.S. source taxable income; to the extent that an expenditure is properly matched with U.S. source gross income, the corporation's U.S. tax will be reduced. For a U.S. corporation, the amount of the credit for foreign income taxes is a function of the amount of its foreign source income. To the extent that an expenditure is properly matched to foreign source gross income, the amount of the credit will be reduced, which will increase the amount of its U.S. tax. For the rules on matching expenditures with U.S. or foreign source income, which can serve as guidance for the states, see Treas. Reg. § 1.861-8.